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COMMENTS

THE EFFECT OF THE TAX REFORM ACT OF 1984 ON ALIMONY AND TRANSFERS OF PROPERTY INCIDENT TO DIVORCE

The Tax Reform Act of 1984¹ made substantial changes affecting the tax consequences of divorce. This comment will focus on the changes made in the tax treatment of transfers of property incident to divorce,² in the definitional requirements of alimony and separate maintenance,³ and on the changes affecting "alimony" trusts and other forms of property.⁴ It will then analyze these changes by contrasting them, in light of congressional intent, with their pre-Tax Act development and treatment and attempt to draw some conclusions with respect to their effectiveness. Other changes affecting domestic relations are not within the scope of this comment.⁵

I. TRANSFERS OF PROPERTY

A. Background

In 1962, the United States Supreme Court settled lower court conflict regarding the taxability of property transfers pursuant to divorce.⁶ In *United States v. Davis*,⁷ the Court held that the transfer of property

1. The Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of I.R.C.) is divided into two divisions. "Division A" is the Tax Reform Act of 1984 [hereinafter cited as Tax Act].

2. See *infra* notes 6-52 and accompanying text.

3. See *infra* notes 53-140 and accompanying text.

4. See *infra* notes 141-156 and accompanying text.

5. The Tax Act, *supra* note 1, also made changes in the rules relating to the dependency exemption, Pub. L. No. 98-369, § 423, 98 Stat. 799 (codified in scattered sections of I.R.C.); innocent spouse rules, Pub. L. No. 98-369, § 424, 98 Stat. 801 (same); and in the gift and estate tax provisions of certain property settlements, Pub. L. No. 98-369, § 425, 98 Stat. 803 (same).

6. The courts of appeals had reached different conclusions on the taxability of transfers of appreciated property. See, e.g., *Commissioner v. Marshman*, 279 F.2d 27 (6th Cir. 1960) (transfer nontaxable); *Commissioner v. Mesta*, 123 F.2d 986 (3d Cir. 1941) (transfer taxable).

7. 370 U.S. 65 (1962). For a detailed study of the *Davis* rule, see DuCanto, *Federal Tax Law: Where You Divorce Does Make a Difference*, 9 LOY. U. CHI. L.J. 397 (1978); Gunn, *The Federal Income Tax Effects of the Missouri Version of the Uniform Divorce Act*, 1974 WASH. U.L.Q. 227; Schwartz, *Divorce and Taxes: New Aspects of the Davis Denouement*, 15

from one spouse to the other, in full or partial release of inchoate marital rights,⁸ would constitute a taxable event unless the transfer was an equal division of co-owned property.⁹

State law controlled the question of whether a transfer of property was an equal "division" of co-owned property (nontaxable) or an "exchange" in release of inchoate marital rights (taxable).¹⁰ Spouses divorced in community property states¹¹ would most likely¹² find their transfers a nontaxable division of property because, in those states, "all property acquired during marriage is considered to be owned by both spouses equally."¹³ Spouses in common law jurisdictions, however, would be subject to a taxable exchange unless the transfer was an equal division of "property previously held in joint tenancy or tenancy by the entirety."¹⁴ Therefore, federal tax consequences varied depending on whether the divorced spouses were domiciled in a community property or common law state.¹⁵

The *Davis* decision was met with a plethora of harsh criticism, mainly

U.C.L.A. L. REV. 176 (1967); Weinstock & Walzer, *Tax Aspects of Divorce in Community Property and Noncommunity Property States*, 42 TAXES 386 (1964); Note, *The Effect of Recent Statutory Changes in Minnesota on the Taxation of Property Transfers Upon Dissolution of Marriage*, 65 MINN. L. REV. 127 (1980) [hereinafter cited as Note, *Statutory Changes in Minnesota*]; Note, *Should Federal Income Tax Consequences of Divorce Depend on State Property Law?*, 49 S. CAL. L. REV. 1401 (1976) [hereinafter cited as Note, *Divorce and State Property Law*]; Comment, *The Federal Income Tax Consequences of Property Settlements in Common Law States and Under the Uniform Marriage and Divorce Act: A Proposal*, 29 ME. L. REV. 73 (1977); Comment, *Transfer of Appreciated Property Pursuant to Divorce: Taxable Event in Oregon?*, 53 OR. L. REV. 544 (1974).

8. Inchoate marital rights refer to those common law or statutory rights which will vest upon the death of the other spouse. See, e.g., *Davis*, 370 U.S. at 65 n.3.

9. *Id.* at 71-73. The court disagreed with the holding of the Sixth Circuit in *Marshman*, which had held that the event was nontaxable because the value of the inchoate marital rights was indeterminable. The Court reasoned that a divorce was an *arm's length* transaction and, accordingly, the value of the inchoate marital rights would be equal to the fair market value of the property received. *Id.*

10. *Id.* at 70, 71. Although the *Davis* Court recognized that its holding would cause considerable disparity between common law and community property states in the tax treatment of transfers of property incident to divorce, the Court stated that any change was in the province of the legislature. *Id.*

11. Community property states include: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington. See 4A R. POWELL, *THE LAW OF REAL PROPERTY* ¶ 625(2) (1982).

12. Potential problems relating to the impossibility of dividing *specific assets* were laid to rest when the Tax Court held that any good-faith equal division of community property, in the aggregate, would be nontaxable. See Clifford H. Wren, 24 T.C.M. (CCH) 290 (1965); see also Rev. Rul. 76-83, 1976-1 C.B. 213-14 (ruling that if both spouses receive an equal share of the value of the community property then no taxable event occurs). However, unequal divisions in value would constitute a taxable event. See Jean C. Carrieres, 64 T.C. 959 (1975). See generally DuCanto, *supra* note 7.

13. See DuCanto, *supra* note 7, at 397.

14. *Id.*

15. *Id.*

because differences in state law produced seemingly capricious federal tax consequences.¹⁶ Other criticism focused on the harsh tax consequences¹⁷ or asserted that the *Davis* rule was unconstitutional.¹⁸ Many common law states were also unreceptive; believing that their taxpayers were being treated unfairly, they attempted either judicial¹⁹ or legislative²⁰ circumvention. Almost all, however, agreed that there was a need for legislative reform.²¹

B. *Transfers of Property Under the Tax Act*

1. Congressional Intent

Congress recognized that the *Davis* rule,²² governing spousal transfers of property incident to divorce, "[had] not worked well and [had] led to much controversy and litigation."²³ In order to correct these problems, protect unwary divorcing spouses,²⁴ and make the tax laws less intrusive,²⁵ Congress abrogated the *Davis* decision by creating section 1041 to govern the transfer of property between former spouses.²⁶

2. Tax Treatment of Transfers of Property

Under the new law, if property is transferred from one former spouse to the other "incident to divorce,"²⁷ then no gain or loss will be recognized

16. E.g., DuCanto, *supra* note 7; Lepow, *Proposals to Reform the Tax Treatment of Property Division Incident to Divorce—A Splitting Headache*, 10 COMMUNITY PROP. J. 237 (1983); Note, *Divorce and State Property Law*, *supra* note 7; see also Note, *Divorce and State Property Law*, *supra* note 7, at 1406 n.27.

17. See DuCanto, *supra* note 7, at 408.

18. See *id.* at 408; Note, *Divorce and State Property Law*, *supra* note 7, at 1431.

19. See, e.g., *Imel v. United States*, 523 F.2d 853 (10th Cir. 1975). In that case, the Colorado Supreme Court, upon certification from the federal district court in *Imel v. United States*, 375 F. Supp. 1102 (D. Colo. 1974), held a spouse acquired a vested interest in the other spouse's property by filing for divorce. The Tenth Circuit, on appeal, affirmed the holding that no taxable event had occurred because the transfer was in recognition of "vested" property rights. *Imel v. United States*, 523 F.2d at 855. See generally DuCanto, *supra* note 7; Note, *Divorce and State Property Law*, *supra* note 7.

20. Several common law states made changes in the statutory rights of spouses in order to give those spouses substantial ownership interest in property acquired during marriage. See, e.g., Gunn, *supra* note 7; Note, *Statutory Changes in Minnesota*, *supra* note 7.

21. See *supra* notes 16-18.

22. See *supra* text accompanying notes 6-9.

23. H.R. REP. NO. 432, 98th Cong., 2d Sess. 1491 (1984). The conference committee agreed to follow the House bill without making any changes. See H.R. REP. NO. 861, 98th Cong., 2d Sess. 1116 (1984).

24. *Id.*

25. *Id.*

26. See Tax Act, Pub. L. No. 98-369, § 421(a), 98 Stat. 793 (codified as amended in I.R.C. § 1041).

27. See *infra* notes 32-34 and accompanying text.

on the property transferred to the former spouse.²⁸ For income tax purposes, these transfers will be treated as gifts,²⁹ and the transferor's adjusted basis will be "carried-over" to the transferee spouse.³⁰

Transfers are considered to be "incident to the divorce"³¹ if they either "[occur] within one year after the date on which the marriage ceases"³² or "[relate] to the cessation of the marriage."³³ Any transfer made pursuant to a "divorce or separation instrument" and occurring not more than six years after the date on which the marriage ceases will be treated as "related to the cessation of the marriage."³⁴ Any transfer which is not pursuant to a divorce or separation instruments or which occurs more than six years after the cessation of the marriage will be a taxable event as the transfer will be "presumed to be *not* related to the cessation of the marriage."³⁵

Although these transfers are treated as gifts, the rules governing the determination of basis acquired by gift³⁶—providing for a reduced basis in loss situations³⁷—do not apply.³⁸ In all transfers governed by the Tax Act, the transferee spouse will assume the transferor spouse's basis.³⁹

28. I.R.C. § 1041(a) (1984). Transfers of property to third parties on behalf of a former spouse may also qualify for section 1041 nonrecognition. In those situations which qualify, the transfer will be treated as if made directly to the nontransferring spouse and then retransferred to the third party. The deemed retransfer to the third party does *not* qualify for section 1041 nonrecognition treatment. See 49 Fed. Reg. 34,453 (1984) (to be codified at 26 C.F.R. § 1.1041-1T(c)(Q&A9)) (proposed Aug. 31, 1984).

29. I.R.C. § 1041(b)(1) (1984).

30. *Id.* § 1041(b)(2).

31. *Id.* § 1041(c).

32. *Id.* § 1041(c)(1). Even bona fide sales within this period will be treated pursuant to section 1041. See 49 Fed. Reg. 34,453 (1984) (to be codified at 26 C.F.R. § 1.1041-1T(d)(Q&A11)) (proposed Aug. 31, 1984).

33. I.R.C. § 1041(c)(2) (1984).

34. 49 Fed. Reg. 34,453 (1984) (to be codified at 26 C.F.R. § 1.1041-1T(b)(Q&A7)) (proposed Aug. 31, 1984).

35. *Id.* (emphasis added). This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. *Id.* For example, the transfer was not made within the required time period because of legal impediments to the transfer *and* the transfer is effected promptly after the impediment is removed.

36. I.R.C. § 1015(a).

37. Compare *id.* § 1015(a) (providing that the transferee's basis will be equal to the fair market value if the basis in the hands of the transferor is greater than the fair market value) with *id.* § 1041(b)(2) (in all cases, the transferee's basis will be the same as the basis in the hands of the transferor).

38. See Tax Act, *supra* note 1, at § 421(b)(5) (adding I.R.C. § 1015(e), which requires the basis of all property transfers described in I.R.C. § 1041(a) to be determined under I.R.C. § 1041(b)(2)).

39. Generally, this rule means that the transferee will not be subject to recapture as the transferee will step into the shoes of the transferor. See I.R.C. §§ 1245(b)(1) & 1250(d)(1) (1984). However, recapture of investment tax credits may occur if the property transferred to the transferee is not "section 38" property to that transferee. See 49 Fed. Reg. 34,454

The Tax Act's nonrecognition and carry-over rules apply, not only to transfers made in release of inchoate marital rights, but also to transfers made in exchange for cash,⁴⁰ other property, or any other form of consideration.⁴¹ These rules also apply to transfers in trust,⁴² and to transfers of annuity⁴³ and life insurance contracts,⁴⁴ which will be discussed in Part IV of this comment.⁴⁵

3. Effective Date

Except for property transferred pursuant to a divorce or a separation instrument in effect before July 18, 1984, all property transferred incident to divorce after that date will be subject to the new nonrecognition and carry-over rules.⁴⁶ However, if both parties wish to do so, they may elect to have the new provisions apply to all transfers made after December 31, 1983.⁴⁷ In the case of transfers made pursuant to decrees in effect before July 18, 1984, the parties may also elect to have these new provisions apply.⁴⁸

C. *Impact of the Changes*

The Tax Reform Act of 1984 should prove very successful in accomplishing Congress' objectives regarding transfers of property incident to divorce.⁴⁹ Its rules are simple and absolute; if property is transferred incident to a divorce, the event will be nontaxable.⁵⁰ As a result of the Tax Act, state property laws will no longer control federal income tax consequences. Although this rule will not prevent or discourage litigation to determine which particular items of property will be transferred, the need for litigation regarding the taxability of such transfers has been eliminated.

These changes will also be more equitable because they will be uniform and will not result in unintended tax consequences. Moreover, the changes will provide the certainty needed in order for the parties to a

(1984) (to be codified at 26 C.F.R. § 1.1041-1T(d)(Q&A13) (proposed Aug. 31, 1984).

40. Care should be taken if property is transferred in exchange for cash as it may trigger alimony treatment. *See infra* notes 98-107 and accompanying text.

41. H.R. REP. No. 432, 98th Cong., 2d Sess. 1492 (1984).

42. *See infra* notes 143-53 and accompanying text.

43. *See infra* note 154 and accompanying text.

44. *See infra* notes 155-56 and accompanying text.

45. *See infra* notes 141-56 and accompanying text.

46. 49 Fed. Reg. 34,454 (1984) (to be codified at 26 C.F.R. § 1.1041-1T(f)(Q&A15-16)) (proposed Aug. 31, 1984).

47. *Id.*

48. *Id.*

49. *See supra* notes 22-26 and accompanying text.

50. *See supra* notes 27-35 and accompanying text.

divorce to plan their settlements with definite tax consequences in mind.

The only drawback to the Tax Act is that it may be inflexible. Its rigid provisions may preclude many transfers that were once entered into because of the taxability of the event.⁵¹ In its entirety, however, the Tax Act provides the much needed remedy to the pre-Tax Act rules governing transfers of property incident to divorce.⁵²

II. ALIMONY AND SEPARATE MAINTENANCE

A. Background

Prior to 1942, payments made by one former spouse to the other for alimony were not deductible by the payor spouse or includable by the recipient spouse in computing their respective federal taxable incomes.⁵³ In that year, Congress recognized that, due in part to the substantially increased federal tax rates necessary to finance World War II,⁵⁴ it became increasingly burdensome for an individual to pay alimony out of after-tax income.⁵⁵ To alleviate some of this burden, the Revenue Act of 1942⁵⁶ created sections 22(k) and 23(u) of the 1939 Code which required certain alimony payments to be included in the taxable income of the payee spouse and deducted by the payor spouse as an itemized deduction.⁵⁷

When the 1939 Code was revised in 1954, these provisions were extended to apply to payments for separate maintenance under a support decree and became sections 71 and 215, respectively, of the 1954 Code.⁵⁸

51. There were many situations where a transferee spouse was amenable to the transfer of property because the transferee was allowed to receive the property with a basis equal to the fair market value. For example, the *transferee* may have been amenable to receiving stock with a fair market value of \$50,000 and a basis of \$10,000 because he or she could sell the stock for \$50,000 without recognizing any gain. Under the new rules, the same type of transaction may be precluded because the transferee will not be amenable to recognizing a gain on retransfer; the transferor may have to resort to a third party or straw party transaction in order to increase the basis to fair market value before the transfer would be amenable to the transferee spouse. Great care should be taken if the transfer is made to a third party. See *supra* note 28.

52. Although beyond the scope of this comment, it must be pointed out that the new rules of nonrecognition and carry-over basis also apply to all transfers between *married* spouses unless the transferee spouse is a nonresident alien. See 49 Fed. Reg. 34,452-53 (1984) (to be codified at 26 C.F.R. § 1.1041-1T(a)(Q&A1-2)) (proposed Aug. 31, 1984).

53. *Gould v. Gould*, 245 U.S. 151 (1917).

54. The Revenue Act of 1942, 56 Stat. 798 (1942) substantially increased normal and surtax rates and also imposed an additional victory tax.

55. See 88 CONG. REC. 6575 (1942).

56. 56 Stat. 798 (1942).

57. See Gornick, *Alimony and the Income Tax: Background And Effect Of The Provisions In The Revenue Act Of 1942*, 29 CORNELL L. REV. 28, 29 n.1 (1943). See generally Johnson, *Divorce and Federal Income Tax*, 37 MINN. L. REV. 413 (1953); Kramer, *Alimony and the Tax Law*, 26 TAXES 1105 (1948).

58. See Lynch, *I.R.C. Section 71: Breaking Up is Hard to Do*, 20 DUQ. L. REV. 173, 176

Except for minor revisions in 1976, which allowed alimony and separate maintenance to be deducted in arriving at adjusted gross income,⁵⁹ these provisions remained largely unchanged until the Tax Reform Act of 1984.⁶⁰

Conceptually, the tax treatment of alimony and separate maintenance has been and continues to be quite simple. Alimony payments or payments to a spouse "in the nature of or in lieu of alimony or an allowance for support as between spouses who are divorced or separated"⁶¹ are includable to the payee spouse⁶² and deductible by the payor spouse.⁶³ In practice, however, the pre-Tax Act definitional requirements were so confusing that it was difficult to determine whether certain payments would be deemed alimony.⁶⁴

1. Statutory Requirements

Generally, payments to which the pre-Tax Act rules apply⁶⁵ qualified for treatment under section 71 and were includable in the recipient spouse's gross income if the following four requirements were met:

(1) The payment would have to be made in discharge of a legal obligation imposed on, or incurred because of, the marital or family relationship.⁶⁶

(2) The payment would have to be "imposed . . . under [a] decree or

n.8 (1982).

59. The Tax Reform Act of 1976, Pub. L. No. 94-455, § 502(a) (codified as amended in I.R.C. § 62). For a detailed analysis of the effects of the Tax Reform Act of 1976 on alimony and separate maintenance, see Comment, *Income Taxation: The Tax Reform Act of 1976 Changes the Treatment of the Individual Taxpayer's Alimony and Child Care Payments*, 9 CUM. L. REV. 177 (1978); Comment, *Federal Income Tax Consequences of Divorce and Separation*, 16 J. FAM. L. 779 (1977).

60. See *infra* notes 97-124 and accompanying text. For a detailed analysis of the laws governing alimony and child support prior to the changes made by the Tax Reform Act of 1984; see Basi & Weinstein, *The Internal Revenue Code and Its Impact on Divorce Settlements*, 53 TAXES 132 (1975); Lynch, *supra* note 58; McClennen, *Tax Aspects of Divorce Settlement Agreements*, 4 ARIZ. L. REV. 26 (1962); Meldman & Ryan, *The Federal Tax Consequences Of Divorce*, 57 MARQ. L. REV. 229 (1974); Rosenkranz, *Divorce and the Federal Income Tax*, 16 U. FLA. L. REV. 1 (1963); Schnee, *Taxation of Divorce: Review and Update*, 62 TAXES 33 (1984); Schwartz, *Income Tax Aspects of Alimony*, 42 TAXES 323 (1964); Note, *Taxation of Alimony*, 16 HASTINGS L.J. 608 (1965); Comment, *Federal Tax Consequences In Divorce and Separation*, 7 UTAH L. REV. 385 (1961).

61. Treas. Reg. § 1.71-1(a) (1957) (amended 1984).

62. I.R.C. § 71(a) (1954) (amended 1984).

63. *Id.* § 215(a).

64. See generally Davies, *The Taxation of Alimony: Policies, Problems and a Proposal*, 31 U. MIAMI L. REV. 1355 (1977).

65. See *infra* notes 131-33 and accompanying text.

66. I.R.C. § 71(a)(1) to (3) (1954) (amended July 18, 1984).

. . . written instrument incident to such divorce or separation,"⁶⁷ pursuant to a written separation agreement,⁶⁸ or required under a decree for support or maintenance.⁶⁹

(3) The payment would have to be "periodic."⁷⁰

(4) The payment could not have been "fixed" as a sum payable for child support.⁷¹

Installment payments discharging part of a principal sum specified in a decree, instrument or agreement would not be treated as "periodic."⁷² However, if the installments continue for more than ten years, then those payments would be treated as "periodic" but only to the extent of ten percent of the principal sum.⁷³

If payments qualified for treatment under section 71,⁷⁴ then under section 215 they could be deducted by the payor spouse in arriving at adjusted gross income.⁷⁵ This rule applied to any payments except for distributions of property in trust, from annuity contracts or from life insurance contracts. These exceptions are discussed in Part IV of this comment.⁷⁶

2. Judicial Amplification

The taxpayer and the Commissioner, natural adversaries, did not always agree on whether certain payments qualified for treatment under sections 71 and 215. Ambiguous drafting and lack of congressional guidance⁷⁷ created several gray areas within the statute. Common among these differences were disputes regarding whether payments were made under a legal obligation,⁷⁸ whether the payments were property distributions *versus* payments in the nature of alimony support,⁷⁹ or whether they were alimony *versus* child support.⁸⁰

67. *Id.* § 71(a)(1).

68. *Id.* § 71(a)(2).

69. *Id.* § 71(a)(3).

70. *Id.* § 71(a)(1) to (3).

71. *Id.* § 71(b).

72. *Id.* § 71(c)(1).

73. *Id.* § 71(c)(2).

74. *See supra* text accompanying notes 66-73.

75. I.R.C. § 215(a) (1954) (amended 1984).

76. *See infra* notes 141-56 and accompanying text.

77. *See, e.g.,* Lynch, *supra* note 58, at n.12.

78. *See, e.g.,* Taylor v. Campbell, 335 F.2d 841 (5th Cir. 1964); *cf.* Knobler v. Commissioner, 59 T.C. 261 (1972). *See generally* Lynch, *supra* note 58.

79. *See, e.g.,* Mills v. Commissioner, 442 F.2d 1149 (10th Cir. 1971). *See generally* Lynch, *supra* note 58; Comment, *Divorce and State Property Laws*, *supra* note 7.

80. *See, e.g.,* Commissioner v. Lester, 366 U.S. 299 (1961) (holding that where an instrument does not state a specific amount that is payable only for child support, then no portion

Judicial interpretation did not provide the needed guidance. Many courts magnified the statutory shortcomings.⁸¹ Others contributed to the uncertainty—in spite of congressional intent that the statute be applied uniformly⁸²—by basing their decisions on determinations made with reference to state law.⁸³

The confusion which resulted from both the statutory inadequacies and the judicial interpretations led many commentators to call for reform.⁸⁴ Indeed, some courts had even recognized that the law had become so perplexing that most lawyers could not plan for or understand the tax consequences incident to divorce.⁸⁵

B. *Alimony Under the Tax Act*

1. Congressional Intent

Congress recognized that the pre-Tax Act definitional requirements of alimony were not sufficiently objective⁸⁶ and resulted in different federal tax consequences because of differences in state law.⁸⁷ In order to rectify these problems and make tax determinations easier for both the Internal Revenue Service and the parties to a divorce,⁸⁸ Congress enacted section 422 of the Tax Act.⁸⁹ This section attempts to redefine alimony “in a way that would conform to general notions of what type of payments constitute alimony.”⁹⁰

The Tax Act does not change the treatment of alimony and separate maintenance—payments which qualify must still be included in the gross income of the recipient spouse⁹¹ and deducted by the payor spouse.⁹² It does, however, drastically change the definitional requirements of ali-

of the payment will be treated as alimony). *See generally* Basi & Weinstein, *supra* note 60; Whinery, *Tax and Non-Tax Negotiations In Alimony and Support After The Lester Case*, 15 OKLA. L. REV. 1 (1962); Recent Decisions, *Taxation—Income Tax—Deduction Allowed Husband For Entire Alimony Payment to Wife Unless a Portion Thereof Is Specifically Designated For Child Support*, 15 VAND. L. REV. 298 (1961).

81. *See* Lynch, *supra* note 58, at 181.

82. *Id.* at 179 n.20.

83. *Id.* at 181-89.

84. *See, e.g.,* Davies, *The Taxation of Alimony: Policies, Problems and a Proposal*, 31 U. MIAMI L. REV. 1355 (1977); Lynch *supra* note 61; Phillips, *Separated Under State Law May Not Be Separated for Purposes of the Section 215 Deduction and Section 71 Inclusion*, 60 TAXES 720 (1982).

85. *See* Lynch, *supra* note 58, at 175 n.3.

86. H.R. REP. No. 432, 98th Cong., 2d Sess. 1495 (1984).

87. *Id.*

88. *Id.*

89. *See* Tax Act, Pub. L. No. 98-369, § 422, 98 Stat. 795 (codified in I.R.C. §§ 71 & 215).

90. H.R. REP. No. 432, 98th Cong., 2d Sess. 1495 (1984).

91. I.R.C. § 71(a) (1984).

92. *Id.*

mony and separate maintenance.

2. Definitional Requirements Under the Tax Act

In order for payments to qualify under the new provisions of section 71,⁹³ all of the following requirements must be met:

(1) The payment must be in cash.⁹⁴ Transfers of property or services, use of property by the payee, or the execution of a debt instrument will no longer qualify as alimony.⁹⁵

(2) The payment must be made pursuant to a "divorce or separation instrument"⁹⁶ which encompasses a "decree of divorce or separate maintenance[,] . . . a written instrument incident to such [decree],"⁹⁷ a written separation agreement⁹⁸ or other types of decrees for the support or the maintenance of the other spouse.⁹⁹

(3) The payment must not be designated as an amount which will *not* be treated as alimony.¹⁰⁰ This provision allows spouses to elect to treat otherwise qualifying payments as non-qualifying payments.

(4) There must be no liability for the payor spouse to make any payment or substitute payment after the death of the payee spouse and the divorce or separation instrument *must* state that there is no such liability.¹⁰¹

(5) In the case of spouses legally separated under a decree of divorce or separate maintenance, the spouses must not be members of the same household when the payment is made.¹⁰²

93. See *supra* note 89.

94. I.R.C. § 71(b)(1) (1984).

95. See 49 Fed. Reg. 34,455 (1984) (to be codified at 26 C.F.R. § 1.71-1T(b)(Q&A5)) (proposed Aug. 31, 1984).

96. I.R.C. § 71(b)(2) (1984). These are the same instruments described in I.R.C. § 71 (1954) (amended 1984). See 49 Fed. Reg. 34,455 (1984) (to be codified at 26 C.F.R. § 1.71-1T(a)(Q&A4)) (proposed Aug. 31, 1984).

97. I.R.C. § 71(b)(2)(A) (1984).

98. *Id.* § 71(b)(2)(B).

99. *Id.* § 71(b)(2)(C).

100. *Id.* § 71(b)(1)(B). See also 49 Fed. Reg. 34,455 (1984) (to be codified at 26 C.F.R. § 1.71-1T(b)(Q&A8)) (proposed Aug. 31, 1984) (setting forth specific guidelines for making an election to treat otherwise qualifying section 71 payments as nonqualifying payments).

101. I.R.C. § 71(b)(1)(D) (1984). See also 49 Fed. Reg. 34,456 (1984) (to be codified at 26 C.F.R. § 1.71-1T(b)(Q&A11)) (proposed Aug. 31, 1984).

102. I.R.C. § 71(b)(1)(C) (1984). The proposed regulations state that spouses *not* legally separated may be able to treat payments made pursuant to an instrument described in section 71(b)(2)(C) as alimony notwithstanding the fact that they are members of the same household. 49 Fed. Reg. 34,456 (1984) (to be codified at 26 C.F.R. § 1.71-1T(B)(Q&A9)) (proposed Aug. 31, 1984).

(6) The spouses must not file a joint return.¹⁰³

3. Special Requirements

Payments which meet the definitional requirements for alimony will qualify for section 71 and 215 treatment if they do not violate the special rules related to contingencies involving children¹⁰⁴ and excess front loading of alimony payments.¹⁰⁵

a. Child Support Contingencies

As before, amounts "fixed" for child support are not treated as alimony¹⁰⁶ and as such are not includable in the payee spouse's gross income. But, the rules for determining whether a payment is "fixed" for child support have been drastically changed. Under the Tax Act, payments will be considered to be fixed for child support if they are reduced by a contingency related to a child, "such as attaining a specified age, marrying, dying, leaving school, or a similar contingency,"¹⁰⁷ or if the payments can be clearly associated with a contingency related to a child.¹⁰⁸ Thus, the rule in *Commissioner v. Lester*¹⁰⁹ is overturned and the presumption will be that payments are for child support if they are reduced on the happening of a contingency related to a child. For example, if an agreement provides that payments (not otherwise specified for child support) to a spouse will be reduced by \$100 when a child reaches eighteen, then \$100 will be treated as though it is fixed for child support. Therefore, it will not be deductible by the payor spouse.¹¹⁰

103. I.R.C. § 71(e) (1984).

104. See *infra* notes 106-110 and accompanying text.

105. See *infra* notes 112-30 and accompanying text.

106. Compare I.R.C. § 71(b) (1954) (amended July 18, 1984) with I.R.C. § 71(c)(1) (1984).

107. I.R.C. § 71(c)(2)(A) (1984).

108. I.R.C. § 71(c)(2)(B) (1984). The proposed regulations describe two situations in which otherwise qualifying payments will be presumed to be reduced at a time clearly associated with the happening of a contingency relating to a child of the payor. The first is where the payments are to be reduced not more than six months before or after the child reaches eighteen, twenty-one, or the local age of majority. The second situation is where the payments are to be reduced at two or more points in time which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of eighteen and twenty-four, inclusive. The presumption in these situations may be rebutted by showing that the time at which the payments are to be reduced was determined independently of the child or it may be rebutted conclusively if the reduction is a complete cessation of the payments during the sixth post-separation year. 26 C.F.R. § 1.71-1T(c)(Q&A18) (proposed Aug. 31, 1984).

109. 366 U.S. 299 (1961).

110. Any payment which is insufficient to cover both alimony and child support will first be applied to such child support. I.R.C. § 71(c)(3) (1984).

b. Rules to Prevent Excess Front Loading of Alimony

Congress clearly sought to prevent large, one-time, lump-sum payments, which are really property settlements, from being treated as alimony.¹¹¹ To accomplish this, two special rules are imposed upon any payments over \$10,000.¹¹²

The first rule sets a minimum term which must be met in order for any payments, to the extent they *exceed \$10,000 during any calendar year*, to qualify as alimony.¹¹³ It requires payments to be made for a minimum of six "post-separation years," which are the six years beginning in the year in which the first payment is to be made.¹¹⁴ For example, if *H* is required under a "divorce or separation instrument"¹¹⁵ to pay *W* \$25,000 per year for five years after they are divorced or separated and no payments are to follow, then only \$10,000 would qualify as alimony in years one through five. If, however, *H* was also required to make a payment of *one dollar* in year six, then the \$15,000 per year excess would also qualify as alimony—subject to the recapture rules discussed below.

The second rule provides for the recapture of certain excess alimony payments.¹¹⁶ Under this so-called "recapture" rule, if payments decrease by more than \$10,000 during the six year post-separation period, then part of the earlier years' payment(s) will be recharacterized.¹¹⁷ The amount recharacterized will be includable in the payor spouse's gross income¹¹⁸ and deductible by the payee spouse.¹¹⁹ An example will clarify the application of this rule.

If *W* is required to make payments to *H* of \$55,000 in year Y1, \$43,000 in year Y2, \$30,000 in year Y3, and \$25,000 per year in years Y4 through Y6, the "recapture" rule would produce the following results:

In computation year¹²⁰ Y2, the excess of the payment in the prior year¹²¹ (Y1) of \$55,000 over the current year payment of \$43,000 as increased by the statutory exemption of \$10,000¹²² (\$53,000) would result in

111. H.R. REP. NO. 432, 98th Cong., 2d Sess. 1495 (1984).

112. See *infra* notes 113-30 and accompanying text.

113. See I.R.C. § 71(f)(1) (1984).

114. *Id.*; see also 49 Fed. Reg. 34,457 (1984) (to be codified at 26 C.F.R. § 1.71-1T(d)(Q&A22)) (proposed regulations relating the excess front loading of alimony payments).

115. See *supra* notes 100-03 and accompanying text.

116. See I.R.C. § 71(f)(2) to (3) (1984).

117. I.R.C. § 71(f)(2) (1984).

118. *Id.* § 71(f)(2)(A).

119. *Id.* § 71(f)(2)(B).

120. Computation year means the post-separation year for which the excess is being determined. *Id.* § 71(f)(4)(B).

121. See *id.* § 71(f)(3)(A)(i).

122. See *id.* § 71(f)(3)(A)(ii).

a \$2,000 excess or recapture (\$55,000 - 53,000) which would be includable by the payor spouse, *W*, and deductible by the payee spouse *H* in the computation year.¹²³

Computation year Y3 would result in recapture of \$3,000 from payments in year Y2 and \$13,000 from the "modified payments,"¹²⁴ which are the actual payments made in that year reduced by any amount previously recaptured with respect to that year, of \$53,000 (\$55,000 - 2,000) in year Y1.¹²⁵

Computation year Y4 would result in no recapture from payments in year Y3, but recapture of \$5,000 from payments in years Y2 and Y1.¹²⁶

No recapture would occur in years Y5 or Y6 because none of the prior years would have "modified" payments of more than \$35,000.¹²⁷ Hence, there will be no excess over the payments of \$25,000 as increased by the \$10,000 statutory exemption.

123.

Computation Year Y2:

Payments in Year Y1	\$55,000	
Less: Payment in Year Y2	\$43,000	
Exemption	<u>10,000</u>	<u>53,000</u>
Excess (Recapture Amount)		<u>\$ 2,000</u>

124. See I.R.C. § 71(f)(3) (1984).

125.

Computation Year Y3:

Recapture from Year Y2:		
Payments in Year Y2	\$43,000	
Less: Payments in Year Y3	\$30,000	
Exemption	<u>10,000</u>	<u>40,000</u>
Excess (Recapture Amount)		<u>\$ 3,000</u>

Recapture from Year Y1:		
Payments in Year Y1	\$55,000	
Less: Previous Recapture	<u>2,000</u>	
Modified Payments from Y1		\$53,000
Less: Payment in Y3	\$30,000	
Exemption	<u>10,000</u>	<u>40,000</u>
Excess (Recapture Amount)		<u>\$13,000</u>

126. The decrease from years Y3 to Y4 is less than \$10,000 (\$30,000 - 25,000), therefore, there will be no recapture attributable to year Y3. As the modified payments for years Y1 and Y2 are both equal to \$40,000 (\$55,000 - (2,000 + 13,000)) and (\$43,000 - 3,000), respectively, then \$5,000 will be recaptured from both of those years. (\$40,000 - (\$25,000 + 10,000)).

127. With the \$5,000 recapture from both years Y1 and Y2 in computation year Y4 modified payments for years Y1, Y2 and Y3 will all equal \$35,000. Y1 = (\$55,000 - (\$2,000 + 13,000 + 5,000)) = \$35,000. Y2 = (\$43,000 - (\$3,000 + 5,000)) = \$35,000. Y3 = \$35,000.

These recapture provisions will not apply to payments which cease by reason of the death or remarriage of one of the spouses¹²⁸ or to payments which are fixed as a percentage "of the income from a business or property or from compensation for employment or self-employment."¹²⁹ Certain support payments may also be exempt from recapture.¹³⁰

4. Effective Date

These definitional requirements¹³¹ must be applied to all "divorce or separation instruments" executed after December 31, 1984.¹³² They *may* also be applied to instruments executed on or before that date, but only if the instrument is modified after that date and *expressly* provides that the amended Code provisions will apply to the modified instrument.¹³³

5. Requirements for Furnishing Identification Numbers

The Tax Act authorizes the Internal Revenue Service to require the payor spouse to furnish the payee's taxpayer identification number and to require the payee spouse to furnish his or her identification number to the payor spouse.¹³⁴ Failure to comply with either of these requirements may result in a \$50 fine.¹³⁵

C. *Impact of the Changes*

As with property transfers, the Tax Act's provisions which change the definitional requirements of alimony and separate maintenance¹³⁶ should prove very successful in accomplishing Congress' specific goals.¹³⁷

In order for payments to qualify for treatment as alimony or separate maintenance, they must meet specific objective requirements which will be determined without reference to state law. Also, the *Lester* rule, which created much confusion and litigation regarding whether payments were sufficiently "fixed" for child support,¹³⁸ has been abrogated. As a result, the parties to a divorce and the Internal Revenue Service will be afforded

128. I.R.C. § 71(f)(5)(A) (1984).

129. *Id.* § 71(f)(5)(C).

130. *Id.* § 71(f)(5)(B).

131. See *supra* notes 93-130 and accompanying text.

132. See Tax Act, Pub. L. No. 98-369, § 422(e)(1), 98 Stat. 795 (1984). See also 49 Fed. Reg. 34,458 (1984) (to be codified at 26 C.F.R. § 1.71-1T(e)(Q&A26)) (proposed Aug. 31, 1984).

133. See Tax Act, Pub. L. No. 98-369, § 422(e)(2), 98 Stat. 795 (1984).

134. See H.R. REP. No. 432, 98th Cong., 2d Sess. 1496 (1984).

135. *Id.*

136. See *supra* notes 93-130 and accompanying text.

137. See *supra* notes 86-90 and accompanying text.

138. Commissioner v. Lester, 366 U.S. 299 (1961). See also *supra* note 80.

much greater certainty with respect to the tax treatment of certain types of payments. This result, in turn, should lead to less litigation.

In achieving the desired certainty, however, the provisions of the new law are necessarily very technical and very specific.¹³⁹ As such, these technical requirements represent a potential trap to the unwary attorney. Great care should be taken to draft divorce or separation instruments in light of these requirements and their associated tax consequences.

The "minimum term" and "recapture" rules should also provide enough of an economic disincentive to prevent "excess front loading of alimony." As such, they will be effective in deterring large, one-time, lump-sum payments from being made in the early "post separation period." However, as drafted, the statute may provide the economic incentive necessary to cause a deferment of a lump-sum payment in the sixth post separation year or later.¹⁴⁰

Thus, the new provisions governing alimony and separate maintenance should provide the much needed relief from the confused and convoluted rules of the pre-Tax Act law.

III. HYBRID TRANSFERS

When a payee spouse receives cash distributions which would represent both income and principal in the hands of payor spouse, these distributions will fall under both the new provisions relating to transfers of property¹⁴¹ and alimony and separate maintenance payments.¹⁴²

A. *Alimony Trusts*

1. Brief Background

Under pre-Tax Act law, two types of trusts might be encountered in connection with a divorce.¹⁴³ One, called a "Section 682" trust, was typically created before, and not in contemplation of, the divorce or separation.¹⁴⁴ The other type of trust, called a "Section 71" or "Alimony" trust,

139. See *supra* notes 93-130.

140. As recapture occurs only if payments *decrease* by more than \$10,000, see I.R.C. § 71(f) (1984), no recapture would occur if a very large lump-sum payment was made in the sixth year or later as long as the minimum term rule was met. See I.R.C. § 71(f)(1) (1984).

141. See *supra* notes 27-48 and accompanying text.

142. See *supra* notes 93-135 and accompanying text.

143. See generally Basi & Weinstein, *supra* note 60; Davies, *supra* note 64; Fink, *Income, Gift, and Estate Tax Aspects of Alimony Trusts*, 119 Tr. & Est. 54 (Mar. 1980); Gornick, *Taxation of Alimony Trusts—A Need for Congressional Reform*, 20 TAXES 529 (1942); Gunn, *Douglas v. Willcuts, Today: The Income Tax Problems of Using Alimony Trusts*, 63 CORNELL L. REV. 1022 (1978); Note, *Alimony Trust Income: A Challenge to Taxability*, 4 VAL. U.L. REV. 181 (1969).

144. See Davies, *supra* note 64, at 1366.

was created incident to a decree of divorce or separate maintenance.¹⁴⁵

Income from a "Section 682" trust, to which a payee spouse was entitled, would have been taxable to the payee spouse and not to the settlor spouse.¹⁴⁶ Distributions of corpus, however, were not taxable to the payee spouse as the payee would have been treated as a beneficiary of the trust for all purposes.¹⁴⁷

Income from an "Alimony" trust was also taxable to the payee spouse in the same manner. But unlike "Section 682" trusts, distributions from corpus *were includable* in the payee spouse's income.¹⁴⁸ Furthermore, settlor spouses were not allowed to take corresponding section 215 deductions for alimony attributable to distributions from corpus.¹⁴⁹

2. Treatment Under the Tax Act

Although the Tax Act is, arguably, inartfully drafted on this point,¹⁵⁰ congressional intent seems to be that payments made by a trust to a divorced spouse will never be treated as alimony payments.¹⁵¹ Rather, the payee spouse will be treated as a trust beneficiary in the same manner as any other trust beneficiary.¹⁵²

In cases where the transferee spouse only receives a life or term interest of a transfer in trust, the Tax Act also prohibits that spouse from claiming a basis upon the sale or exchange of his or her interest.¹⁵³

B. Other Hybrid Transfers

1. Annuity Contracts

In cases in which an annuity contract is transferred to a former spouse,

145. *Id.* at 1365.

146. I.R.C. § 682(a)(1954) (amended July 18, 1984). *See also* Treas. Reg. § 1.682(a)-1(a)(2) (1957).

147. I.R.C. § 682(b) (1954) (amended July 18, 1984). *See* I.R.C. §§ 652 & 662 (1954).

148. *See* I.R.C. § 71(a)(1)-(2) (1954) (amended July 18, 1984).

149. *See* I.R.C. § 71(d) (1954). *See also* Treas. Reg. § 1.215-1(c) (1957) (amended 1984).

150. Section 71, as amended by the Tax Act, makes no reference to the *source* from which cash is received. I.R.C. § 71(b)(1)(A) (1984). Thus, a cash payment received by a spouse from a trust set up pursuant to a divorce decree, etc., would *literally* qualify as alimony (assuming the other requirements are met).

151. Where . . . a beneficial interest in a trust is transferred or created, incident to divorce or separation, the transferee will be entitled to the usual treatment . . . as the beneficiary of a trust (by reason of sec. 682), notwithstanding that the . . . payments by the trust qualify as alimony or otherwise discharge a support obligation. H.R. REP. No. 432, pt. 2, 98th Cong., 2d Sess. 1492 (1984).

152. *See supra* notes 146-47 and accompanying text.

153. *See* Tax Act, Pub. L. No. 98-269, § 421(b)(4), 98 Stat. 793 (1984) (codified as amended in I.R.C. § 1001(e)(1) (1984)).

the transferee spouse will be able to recover the transferor's "investment in the contract" as a tax free return of basis, notwithstanding the fact that they may literally qualify as alimony.¹⁵⁴

2. Life Insurance Contracts

Many divorce or separation instruments require payor spouses to carry life insurance in order to provide for the continuation of alimony payments after the death of the payor. Because the basis of the contract will carry over to the transferee,¹⁵⁵ the proceeds of the policy will be fully excludable from the transferee spouse's income.¹⁵⁶

IV. CONCLUSION

The Tax Reform Act of 1984 made much needed changes in laws governing transfers of property and alimony and separate maintenance. These changes should eliminate much of the uncertainty in determining the tax consequences of a divorce settlement. This, in turn, should lead to less litigation and a better ability to structure divorce settlements in light of predictable tax consequences. It appears Congress has achieved the goals it set for the Act.

J. Thomas O'Brien, Jr.

154. See H.R. REP. No. 432, pt. 2, 98th Cong., 2d Sess. 1492 (1984); cf. I.R.C. § 1041(b) (1984) (Transferee's basis will be equal to the basis in the hands of the transferor. In essence, the transferee steps into the shoes of the transferor).

155. See I.R.C. § 1041(b) (1984).

156. See H.R. REP. No. 432, pt. 2, 98th Cong., 2d Sess. 1492 (1984).

